Suggested Interim Final Appraisal Independence Regulation Working Draft

September 10, 2010

Preamble

Effective Dates

Title XIV provisions have an effective date tied to implementing regulations. Regulations required by Title XIV must be in final form within 18 months of the designated transfer date, and must take effect within 12 months of their issuance in final form. When the final regulation takes effect, the "section, or provision thereof" in Title XIV takes effect. If a "section" has no regulation 18 months after the designated transfer date, the section is effective 18 months after the designated transfer date.

Section 1472 has a rulewriting provision, as follows. The Board, OCC, FDIC, NCUA, FHFA, and Bureau may jointly issue rules, interpretive guidelines, and general policy statements with respect to acts or practices that violate appraisal independence within the meaning of TILA § 129E(a) through (f), and (i).

The Board must, "for purposes of this section" (referring to TILA § 129E) prescribe an interim final regulation by Wednesday, October 19, 2010 "dealing with specificity acts or practices that violate appraisal independence" and "defining any terms in this section or such regulations."

The TILA § 129E subsections cover the following:

- (a) General prohibition on acts or practices that violate appraisal independence, pursuant to § 129E regulations
- (b) Appraisal independence requirement
- (c) Exceptions for asking an appraiser to consider additional information, etc.
- (d) Prohibitions on conflicts of interest
- (e) Mandatory reporting of failure to comply with USPAP
- (f) Prohibition on extending credit without documenting reasonable diligence on appraisal not misrepresenting value
- (g) Rulemakings
- (h) The several agencies may issue joint rules on appraisal portability
- (i) Customary and reasonable appraisal fee
- (j) HVCC sunsets when Board promulgates its interim final rule
- (k) Penalties

Section 1472 does not state that each provision or subsection of § 129E is an appraisal independence provision, such that it must be implemented in the Board's interim final rule. Additionally, the direction to the Board to write an interim final rule does not specify which provisions the interim final rule must cover. Subsections (e), (f), (h), (i),

and (k) are not directly related to appraisal independence, and the statute nowhere requires that they be implemented in the Board's interim final regulation.

Subsection (h) specifically mentions that the agencies may write a joint rule on portability, so the Board may leave that issue for the joint rule.

Subsection (k) sets civil money penalties for violations of § 129E. While subsection (k) does not require an implementing regulation, it appears that Congress intended it to become effective when any requirement of § 129E becomes effective.

Which Appraisals Are Covered

Section 129E by its terms applies appraisal independence requirements to "a consumer credit transaction secured by the principal dwelling of the consumer[.]" The use of appraisals that are free from inappropriate selection of appraisers, and that are free from coercion or other inappropriate influence over appraisers, is a safe and sound lending practice and a is consumer protection for consumer credit secured by a second home or by a home that a consumer may rent out. For this reason, the interim final regulation applies to consumer credit transactions secured by a consumer's principal dwelling, nonprincipal dwelling, or by a dwelling that the consumer does not occupy.

Appraisal Fees

Subsection (i) warrants specific mention here. It will require lenders to compensate fee appraisers at a rate that is customary and reasonable for appraisal services in the market area where the subject property is located, and continues:

Evidence for such fees may be established by objective third-party information, such as government agency fee schedules, academic studies, and independent private sector surveys. Fee studies shall exclude assignments ordered by known appraisal management companies. . . . In the case of an appraisal involving a complex assignment, the customary and reasonable fee may reflect the increased time, difficulty, and scope of the work required for such an appraisal and include an amount over and above the customary and reasonable fee for non-complex assignments.

This suggests using government agency fee schedules to determine customary and reasonable fees, and VA loans have an appraisal fee schedule, available here: http://www.benefits.va.gov/homeloans/fee_timeliness.asp However, these fees are higher than many consumers will expect to pay (\$450 to 600 in California, for example), and likely are not "reasonable and customary" for non-VA loans. It is likely an implementing regulation will consider a different approach to establishing a reasonable and customary fee.

Another source of "objective third-party" fee information simply does not exist. Additionally, the fee increase for complex assignments will be difficult to define and

pinpoint. It may not be possible to create a source of information, and to define what is a reasonable and customary appraisal fee for both complex and noncomplex loans, for inclusion in an interim final rule, while agencies are transferring staff and functions, by October 19, 2010.

Moreover, the interim final regulation will need to become effective on or close to its publication date because when it is "promulgated[,]" the HVCC sunsets. That means that there will be no time to implement the interim final rule. To the extent that the interim final rule is similar to the HVCC, which is today in force, this should not present an implementation problem.

But if the interim final rule alters appraisal prices, and especially if it increases them, implementation as to loans in the process of origination may be affected. Will creditors need to collect an additional fee and pass it to the appraiser? Would this be a "changed circumstance" within the meaning of 24 C.F.R. § 3500.7(f)(1) such that a revised good faith estimate is permitted?

Moreover, the design of rulemakings under § 1472 is to replace the HVCC within 90 days, and to have a more thorough joint rulemaking, with the full notice and comment process, thereafter. Two facts are relevant here – first, the HVCC does not govern appraisal fees, and, second, the HVCC has already been thoroughly debated, considered, vetted, and implemented. Congress appears to have directed that the HVCC be replaced sooner than a full rulemaking can occur *because* the HVCC has already been through so much debate that a full rulemaking can be avoided. But the other issues in § 1472, such as reasonable and customary appraisal fees, have not been debated, so a full rulemaking is appropriate and is required by the Administrative Procedure Act. Congress appears to have intended to sidestep the normal rulemaking process only for issues that have been debated as the HVCC was formed, and to have required a full rulemaking for issues, such as appraisal fees, that have not been debated.

Further, if the Board were to implement all of § 1472 in its interim final rule, that would disrupt the Congressional plan that several agencies participate in crafting the appraisal rules. If the Board were to implement all of § 1472 by interim final rule, the joint rulemaking would revise the regulations almost as soon as they were written. The Dodd-Frank Act is designed to protect consumers, not to create unnecessary regulatory disruptions.

For these reasons, it appears that Congress intended the interim rule to replace the HVCC but not to delve into new policy areas, such as appraisal fees, that the HVCC does not cover.

Who May Order Appraisals

The HVCC prohibits mortgage brokers and real estate agents from ordering appraisals, while § 129E does not directly address this question. Section 129E does, however, address the question indirectly, by very explicitly requiring appraiser independence, and

by prohibiting any type of collusion with, instruction to, or other improper influence over, an appraiser.

Mortgage brokers and real estate agents have an incentive to see that a mortgage loan closes because their compensation is triggered by loan closings. For this reason, they have an incentive to steer a lender to an appraiser that they believe will result in the highest appraised value. Selection of appraisers based on the expected appraised value, and more specifically on expectation of the highest value, is an unsafe and unsound lending practice, and may result in consumers obtaining loans that are "underwater" or close to it at consummation. This is an inappropriate practice, as can be seen from the current rates of default and foreclosure.

While permitting mortgage brokers and real estate agents to order appraisals, in the past, has permitted appraisals to be somewhat portable, it is not the only method of creating portability. The HVCC attempted to make appraisals portable, but in practice it did not. It required a lender, in accepting an appraisal prepared for a different lender, to obtain written assurances from the first lender that the appraisal was prepared in accordance with the HVCC. Lenders were not willing to provide such assurances for the benefit of a competitor to whom the lender is losing a prospective customer.

Congress directed in § 129E(f) that a creditor may use an appraisal, regardless of whether it was prepared for another, in certain circumstances, although, unlike the HVCC, Congress does not require a creditor to obtain assurances from a creditor for whom an appraisal was performed:

[A] creditor who knows, at or before loan consummation, of a violation of the appraisal independence standards established in subsections (b) or (d) shall not extend credit based on such appraisal unless the creditor documents that the creditor has acted with reasonable diligence to determine that the appraisal does not materially misstate or misrepresent the value of such dwelling.

If a creditor is aware of some uncorrected deficiency, it may not use the appraisal regardless of whether it was prepared for that creditor or another. Conversely, even if it were prepared for another, the creditor may use it if the creditor in good faith determines that it is acceptable. That is, Congress has directed that portability should be determined by the quality of the appraisal.

Suggested Appraisal Independence Interim Final Rule

12 C.F.R. 226.**, Appraisal Independence.

(a) Authority, Purpose, and Scope.

(1) AUTHORITY.—This section is issued by the Board of Governors of the Federal Reserve System to implement only subsection 129E(a) through subsection 129E(d),

paragraph 129E(g)(2), and subsection 129E(k) of the Truth in Lending Act, as enacted by the Mortgage Reform and Anti-Predatory Lending Act.

(2) Purpose.

- (i) IN GENERAL.—This purpose of this section is to implement the mandate, in section 129E(g)(2) of the Truth in Lending Act, that the Board shall prescribe interim final regulations defining with specificity acts or practices that violate appraisal independence in the provision of mortgage lending services for a consumer credit transaction secured by the principal dwelling of the consumer, or mortgage brokerage services for such a transaction.
- (ii) JOINT RULES.—Rules prescribed by the Board in this section are deemed to be rules prescribed by the agencies jointly under paragraph section 129E(g)(1) even though they are prescribed by the Board.
- (3) SCOPE.—This section covers only subsection 129E(a) through subsection 129E(d), paragraph 129E(g)(2), and subsection 129E(k) of the Truth in Lending Act, as enacted by the Mortgage Reform and Anti-Predatory Lending Act. This section does not cover, implement, or affect the effective date of, any other provision or any other section of the Mortgage Reform and Anti-Predatory Lending Act.

(b) Definitions.

In this section, the following definitions apply:

- (1) Affiliate means any company that controls, is controlled by, or is under common control with, another company.
- (2) *Control* of an entity means the ownership, control, or power to vote, directly or indirectly, more than 25 percent of the voting shares, or the equivalent to voting shares, of a company.

(c) Covered Appraisals.

- (1) REQUIREMENTS.—Appraisals covered by this section must meet the requirements of this section.
- (2) COVERED APPRAISALS.—An appraisal is covered by this section if it is all of the following:
 - (i) Of property that is offered or considered as security for repayment of a consumer credit transaction:
 - (ii) Conducted or to be conducted in connection with that consumer credit transaction or possible consumer credit transaction; and
 - (iii) Of a property that is the borrower's or intended borrower's principal dwelling, nonprincipal dwelling, or dwelling that the consumer does not occupy.
- (3) APPRAISALS NOT COVERED.—Nothing in this section shall be construed to apply to an appraisal if:

- (i) It is obtained, performed, or used for purposes other than origination of a consumer credit transaction; or
- (ii) It is one of multiple appraisals a creditor obtains in connection with a loan and the creditor does not rely on it in making that loan. In this event, this section covers only the appraisal upon which the creditor relied.
- (4) TRANSACTION COMPLETION NOT REQUIRED.—An appraisal is not exempt from coverage under this section even if either:
 - (i) The consumer credit transaction does not consummate or has not yet been consummated; or
 - (ii) The appraisal is not completed or has not yet been completed.

(d) Appraiser Engagement Requirements.

Appraisals covered by this section must meet all of the following appraiser engagement requirements.

- (1) INDEPENDENT SELECTION OF APPRAISERS.
 - (i) Except as provided in subparagraph (ii), the creditor or any third party specifically authorized by the creditor (including, but not limited to, appraisal companies, appraisal management companies, and correspondent lenders) must select, retain, and provide for payment of all compensation to, the appraiser.
 - (ii) The creditor shall not accept any appraisal report completed by an appraiser selected, retained, or compensated in any manner by any other third party, including a mortgage broker, real estate agent, real estate broker, or any party acting on behalf of a mortgage broker, real estate agent, or real estate broker.
- (2) PERSONS SUBJECT TO SEPARATION REQUIREMENT.—All of the following persons are subject to this paragraph:
 - (i) All members of the creditor's loan production staff;
 - (ii) A person who is compensated on a commission basis upon the successful consummation of a loan; and
 - (iii) A person who reports, ultimately, to any officer of the creditor not independent of the loan production staff and process.
- (3) SEPARATION OF APPRAISER SELECTION FROM LOAN PRODUCTION.—Persons described in paragraph (2) must not do any of the following:
 - (i) Select, retain, recommend, or influence the selection of, an appraiser for a particular appraisal assignment or for inclusion in a group of appraisers that is either approved to perform, or prevented from performing, appraisals for the creditor; or
 - (ii) Have any substantive communications with an appraiser, appraisal company, or appraisal management company, that relates to or has an impact on the appraised value; or
 - (iii) Order or manage an appraisal assignment.

- (4) SMALL CREDITORS.—If absolute lines of independence cannot be achieved as a result of the creditor's small size and limited staff, to meet the requirements of this paragraph, the creditor must be able to clearly demonstrate that it has prudent safeguards to isolate its collateral evaluation process from influence or interference from its loan production process.
- (5) APPRAISER SELECTION.—Any person who selects appraisers for a creditor or for a group of appraisers that is either approved to perform, or prevented from performing, appraisals for the creditor, for appraisals covered by this section, or for substantive review of those appraisals, must be both:
 - (i) Appropriately trained in real estate appraisal management; and
 - (ii) Wholly independent of the creditor's loan production staff and process.

(e) Appraisal Independence Requirements.

Appraisals covered by this section must meet all of the following appraisal independence requirements.

- (1) INDEPENDENCE REQUIRED.—No person or entity shall, in connection with an appraisal covered by this section, do or attempt to do any of the following:
 - (i) Compensate, coerce, extort, collude, instruct, induce, bribe, or intimidate a person, appraiser, appraisal management company, firm, or other entity conducting or involved in the appraisal, for the purpose of causing the appraised value, in that appraisal, to be based on any factor other than the appraiser's independent judgment and the facts upon which, in the appraiser's independent judgment, are relevant to the appraisal;
 - (ii) Mischaracterize, or suborn any mischaracterization of, the appraised value of the property;
 - (iii) Seek to influence an appraiser or otherwise to encourage a targeted value to facilitate making or pricing the transaction; or
 - (iv) Withhold or threaten to withhold timely payment, or any portion of a payment, for either an appraisal report or appraisal services, when the appraisal report or services are provided in accordance with a contract between the parties.
 - (v) Any person or entity that does or attempts to do any act listed in paragraph (1) is deemed to have "an interest in the underlying transaction" within the meaning of § 129E(b)(1).
- (2) PROHIBITION ON FINANCIAL OR OTHER INTEREST.—Any certified or licensed appraiser conducting, and any appraisal company or appraisal management company procuring or facilitating, an appraisal covered by this section must not have a direct or indirect interest, financial or otherwise, in the property or transaction involving the appraisal. For this purpose, a financial interest in a transaction does not include compensation for appraisals or for appraisal services as long as that compensation is consistent with applicable law.

- (3) AFFILIATIONS.—An appraisal covered by this section that is prepared by any of the following must comply with paragraph (4):
 - (i) An appraiser employed by:
 - (A) The creditor;
 - (B) An affiliate of the creditor;
 - (C) An entity that is owned, in whole or in part, by the creditor; or
 - (D) An entity that owns, in whole or in part, the creditor.
 - (ii) An appraiser employed, engaged as an independent contractor, or otherwise retained by any appraisal company or any appraisal management company affiliated with the creditor.
- (4) REQUIREMENTS FOR AFFILIATED APPRAISERS.—An appraisal prepared by an appraiser identified in paragraph (3) meets the requirements of this subsection if the appraisal meets all of the following requirements:
 - (i) The appraiser or, if the appraiser is employed by the creditor's affiliate, the company for which the appraiser works, must report to a function of the creditor that is independent of sales or loan production;
 - (ii) Employees in the creditor's sales or loan production functions must have no involvement in either:
 - (A) The operations of the appraisal functions; or
 - (B) Selecting, retaining, recommending, or influencing the selection of any appraiser for any particular appraisal or for inclusion in a group of appraisers that is either approved to perform, or prevented from performing, appraisals for the creditor;
 - (iii) Employees in the creditor's sales or loan production function must not:
 - (A) Have any substantive communications with an appraiser, appraisal company, or appraisal management company if that substantive communication relates to or has an impact on the appraised value of an appraisal subject to this section; or
 - (B) Be provided information disclosing the identity of the appraiser that is assigned to an appraisal covered by this section before completion of that appraisal;
 - (iv) The creditor, its agents, and any appraisal company or appraisal management company providing an appraisal to the creditor must not provide the appraiser any estimated or target value of the property or the amount of the loan for which the consumer has applied, but may provide a copy of a sales contract for the subject property;
 - (v) The appraiser's compensation must not depend in any way on either the appraised value the appraiser identifies, or upon consummation of the loan for which the appraisal was ordered;
 - (vi) The creditor and any appraisal company or any appraisal management company providing the appraisal to the creditor must have written policies and procedures

implementing this section, and shall have mechanisms in place to report and discipline anyone who violates those policies and procedures; and

- (vii) The creditor's appraisal functions must be either annually audited by an external auditor, or subject to federal or state regulatory examination.
- (5) REQUIREMENTS FOR AFFILIATED SETTLEMENT SERVICE PROVIDERS.—An appraisal does not meet the requirements of this subsection if it is prepared by an entity affiliated with a third party that the creditor engages to provide settlement services, as defined in the Real Estate Settlement Procedures Act, 12 U.S.C. § 2601 *et seq.*, for the same transaction, other than the appraisal, unless the entity providing the appraisal:
 - (i) Has written policies and procedures implementing this section, including, but not limited to, adequate training and disciplinary rules on appraiser independence; and
 - (ii) Has mechanisms in place to report and discipline anyone who violates these policies and procedures;
- (6) STATE LICENSE OR REGISTRATION REQUIRED.—The appraiser must have the appraiser license or registration required by the law of the state in which the appraised property is located.
- (7) IN-HOUSE STAFF APPRAISERS.—Unless otherwise prohibited by this section, a creditor may use in-house staff appraisers to:
 - (i) Order appraisals;
 - (ii) Conduct appraisal reviews or other quality control, whether pre-funding or post-funding;
 - (iii) Develop, deploy, use, quality-test, inspect, and conduct replication testing of, internal automated valuation models as permitted by applicable law;
 - (iv) Prepare appraisals or perform appraisal services in connection with appraisals, in conformance with this section.

(f) Exceptions.

ERROR PREVENTION PERMITTED.—The requirements of this section shall not be construed as prohibiting any person or entity from asking an appraiser to do any of the following:

- (1) Consider additional, appropriate property information, including the consideration of additional comparable properties to make or support an appraisal;
- (2) Provide further detail, substantiation, or explanation for the appraiser's value conclusion; or
- (3) Correct errors in an appraisal report.
- (g) Appraisal Portability.

- (1) An appraisal prepared for one creditor shall be portable, to be useable by a subsequent creditor, in accordance with this subsection.
- (2) A subsequent creditor that receives an appraisal prepared for an earlier creditor may use that appraisal if the subsequent creditor determines that it is acceptable.
 - (i) The subsequent creditor shall make a good faith effort to determine whether the appraisal is acceptable.
 - (ii) The subsequent creditor may request that an appraiser update an appraisal that was prepared for another creditor.
- (3) Nothing in this section shall be construed to require a creditor to use a particular appraisal.